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# Varieties of Capitalism, Varieties of Vulnerabilities: Financial Crisis and its Impact on Welfare States in Eastern Europe and the Commonwealth of Independent States

*Jan Drahokoupil and Martin Myant* \*

**Abstract:** »Varianten des Kapitalismus – Varianten von Vulnerabilität. Die Finanzkrise und ihre Auswirkungen auf die Wohlfahrtsstaatsregime in Osteuropa und der Gemeinschaft Unabhängiger Staaten«. This paper investigates the implications of the 2008 financial crisis on welfare states and the capitalist diversity in the post-communist world, including Eastern Europe and the Commonwealth of Independent States. It analyzes three political-economic varieties in the region: those of capitalism, welfare, and vulnerabilities to the crisis. The three varieties are linked, but there is also a considerable variation given the importance of political and policy factors. Economic growth models created different political and economic constraints on policies of adjustment to the crisis. In particular, currency substitution was associated with strong political preferences for defending exchange rates, with adjustment through reductions in public spending and wages. A variety of welfare models was associated with different political constituencies for welfare provision. The interplay of these constraints and political factors together with intervention of international institutions shapes the nature of welfare state adjustments. Early developments also indicate some unexpected outcomes.

**Keywords:** financial crisis; welfare state; varieties of capitalism; Eastern Europe; Russia; Commonwealth of Independent States

## Introduction

This contribution analyzes the implication of the global financial crisis of 2008 for Eastern Europe and the Commonwealth of Independent States (CIS).<sup>1</sup> It is concerned with the impact of economic shocks on the capitalist variety in the region. In particular, it analyzes the implications of the crisis for public spend-

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ing and the nature of social protection. Three points will be pursued to understand the impact of the crisis. First, the financial crisis had different implications in different contexts. The capitalist variety in the region also involved different structures of vulnerabilities to external shocks. What is more, the economic strategies were coupled with different welfare models. There were thus important differences in what was at stake in terms of institutions of social protection.

Second, economic growth models created different political and economic constraints on policies of adjustment to the crisis. In particular, currency substitution was associated with strong political preferences for defending (overvalued) exchange rates, with adjustment through reductions in public spending and wages. In turn, a variety of social models was associated with different political constituencies for welfare provision. These are likely to shape the nature of welfare state adjustments.

Third, external actors played an important role. Most notably, the IMF, and in the CIS context also Russia, were an important source of emergency funding. The IMF's loan conditionalities imposed hard constraints on countries with liquidity problems. However, the nature and implications of the conditionalities differed, depending on the context of individual welfare state models.

The argument is structured as follows. After discussing existing conceptualization of the capitalist variety in the region, the paper identifies six models of growth and international integration set against the internal features that were their preconditions. The third section investigates the variety of welfare models as coupled with the capitalist variety. Finally, the impacts of the crisis are analyzed along a four stage framework. In this context, the implications of IMF conditionalities are discussed. The conclusion pulls threads together and assesses the prospects.

### Beyond 'varieties of capitalism'

The economic recovery of the late nineties and early 2000s saw a variety of growth models, with differences in the structure and organization of the economy and in the mode of international integration. Table 1 provides an overview of the international positions of individual economies in 2006, just before the financial crisis started to change the picture. All of the countries experienced problems with achieving external balance, with current account deficits reaching alarming levels in the Baltic States, South-Eastern Europe and a number of poorer countries in the CIS, reflecting their inability to develop competitive export activities to balance imports as well as a failure to control consumption and spending levels. In general, however, these imbalances were not linked to public spending deficits as was the case for crises in South America. The approach taken here characterizes the capitalist variety in the region by analyzing the different modes of growth and nature of international integration, with

internal features of individual countries as their preconditions (Myant and Drahokoupil 2010). It draws on recent advances in the literature on ‘varieties of capitalism’ in transition economies, yet differs in several respects.

As far as the ‘dependent variable’ problem is concerned, the ‘varieties of capitalism’ (VoC) framework developed for the analysis of the most developed market economies (Hall and Soskice 2001) seeks to explain the development and persistence of competitiveness in different branches of economic activity. That remains the starting point: export structures in transition economies show structured differences in terms of their export specialization. However, this needs to be supplemented with a broader view of the modes of growth and international integration. Indeed, attempts to apply the VoC framework in the post-communist context demonstrated that one of the key features of transition economies, differences in the nature of integration into international economic flow beyond differences in export structures, remained exogenous to the framework (for an overview, see Drahokoupil 2009)<sup>2</sup>. The forms of recovery can be presented as different solutions to the problem of financing the persistent current account deficits. The surge in natural-resource prices resolved the problem in countries with natural-resource endowments, but growth models in other countries were dependent on different forms of capital inflows. The salience of these differences became apparent in the aftermath of the crisis.

The ‘independent variables’ in the Hall and Soskice framework are what can be called ‘specific comparative institutional advantages’. These include mutually reinforcing institutional forms that affect strategic interaction of actors within a political economy, allowing companies to construct their core competencies. These include means of raising investments, the forms of corporate governance, the scope of cooperation between firms, and types of employment relationships. Others have expanded the framework to include the role of the state in leading economic development (e.g. Schmidt 2002; Amable 2003; Boyer 2005). The framework offers a number of indicators that can be followed in transition economies; and comparisons have been made on this basis (e.g. Feldmann 2006; Knell and Srholec 2007; Mykhnenko 2007; Buchen 2007). However, such specific institutional advantages are not the key factors in distinguishing the kinds of capitalism in transition economies.

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<sup>2</sup> A similar critique of the ‘Varieties of Framework’ can also be made for its utility in the context of advanced capitalist states (e.g. Pontusson 2005; Panitch and Gindin 2005); a point that became particularly relevant in the context of the global financial crisis.

Table 1: The international position of transition economies, 2006, measures as % of GDP

	Exports				Remittances				
	Current account	Trade balance	Total (% GDP)	Share of complex (%)	Reported (WB)	Estimates (IFAD)	Official aid	FDI stock	Debt
Czech Republic	-2.7	3	66.8	54.9	0.8	1.2		54.8	40.9
Hungary	-5.8	1	65.5	64.5	0.3	0.8		73	94.1
Poland	-2.8	0	34.4	41.5	1.3	1.4		30.6	49.3
Slovakia	-5.7	-4	75.5	50.2	0.8	1.3		55	47.3
Slovenia	-2.8	-1	55.9	47.0	0.8			20	78.5
Azerbaijan	15.6	29	65.6	2.0	4.1	9.3	1	66.9	9.6
Kazakhstan	-2.5	11	48.2	1.8	0.2	6.5	0.2	42	91.5
Russia	9.5	13	31.1	4.5	0.2	1.4	0.2	20.2	91.5
Turkmenistan	12.3	18	58.4	5.3		3.4	0.2	14.3	8.4
Estonia	-16.8	-10	58.8	31.9	2.4	2.3		77.2	102.3
Latvia	-22.7	-20	30.1	18.9	2.4	2.3		37.5	117.9
Lithuania	-10.7	-10	47.4	24.2	3.3	1.6		36.7	63.4
Bulgaria	-18.5	-19	48	16.0	5.4	3.8		65.8	78.2
Romania	-10.4	-10	26.6	30.7	5.5	3.9		33.6	34.3
Croatia	-6.7	-24.7	24.9	32.6	2.9	3.3	0.5	29.2	85.3
Armenia	-1.8	-14	16.1	4.7	18.4	18.5	3.3	26.6	32.4
Georgia	-16.1	-24	21.4	22.9	6.3	20.2	4.7	43	25.4
Kyrgyzstan	-10.6	-37	28.8	9.6	17.1	31.4	11	21	84.5
Moldova	-11.3	-47	31.4		35.2	31.4	6.8	39.6	71.9
Tajikistan	-0.8	-35	12.5	1.7	36.3	36.7	8.5	23	41.1

*Table 1 continued...*

Albania	-7.4	-23.1	8.6	4.1	14.9	21.7	3.5	14.1	20
Ukraine	-1.5	-3	36.6	14.7	0.8	8.0	0.5	21.1	46.9
Belarus	-3.9	-4	60.2	19.8	0.9	6.3	0.2	7.4	16.6
Uzbekistan	18.6	12	33	12.0		17.0	0.9	8.4	22.7
Mongolia	5.6	0.9	49.1	1.0	5.7	7.5	6.4	27.5	42.9
Bosnia-Herzegovina	-11.7	-37.7	29.5	15.2	1.8	20.3	4	38.7	53.8
FYR Macedonia	-0.4	-20.6	38.5		4.2	8.4	3.1	38.3	38.7
Montenegro	-29.1	-50	30		-		3.6	47.8	38.3
Serbia	-12.9	-21.6	22.6	13.5	2.3	11.4*	5	31.8	68.2

Sources: Calculated from World Bank (2008a), UNCTAD (2007), IFAD (2007), and EBRD statistics (available at <<http://www.ebrd.com/country/sector/econo/stats/index.htm>>).

Share of complex sectors calculated from COMTRADE database: <http://comtrade.un.org/db> [complex sectors include the following categories: 7 (Machinery and transport equipment), 54 (Medical and pharmaceutical products), 87 (Professional, scientific and controlling instruments and apparatus, n.e.s.), 88 (Photographic apparatus, equipment and supplies and optical goods, n.e.s.; watches and clocks)]

\*Serbia and Montenegro

In fact, more ‘generic institutional advantages’ proved to be much more important in the context of transition economies. These include state capacity, the rule of law, a functioning system of corporate governance, a stable financial system, clarity of ownership relations, and a separation of politics and business. These issues were either taken for granted or given little attention in the VoC literature, but they proved to be crucial in the evolution of capitalist relations in the CIS. What is more, these institutional advantages arguably played a major role in the path-shaping processes of the early 1990s, contributing to the differences among East European countries (Greskovits 2005).

The internal preconditions shaping the capitalist variety also included (inherited) economic structures and their levels. These ‘structural comparative advantages’ played an important role, particularly in the countries with similar ‘generic institutional advantages’, as was the case in Eastern Europe. Geographical location and political ‘traditions’ are linked to all of these points. Specific policies did matter at some points, particularly in the late nineties when they could make a difference in terms of retaining the structural and institutional advantages. However, choices concerning the pace of liberalization and stabilization measures as well as the speed of privatization appeared to have less an impact by the late 1990s. Other important policy issues included the steps taken to attract FDI and policies towards the financial sector.

### Varieties 1: Modes of growth and international integration

The above considerations lead to the identification of six modes of growth and international integration, set against the internal features of individual countries that were their preconditions. These do not constitute six forms of ‘varieties of capitalism’: every country relied on more than one mode of growth. However, there are differences in the weights of the different forms, and rough country groupings can be identified.

First, the most secure form of international integration, offering the highest incomes, was the export of high-value products manufactured in branches of large multinational companies into western Europe. The dominance of MNCs in determining economic success has justified Nölke and Vliegenthart (2009) to propose a ‘dependent market economies’ model into the ‘Varieties of Capitalism’ framework, with intrafirm hierarchies within transnational enterprises constituting a distinctive coordination mechanism (cf. King 2007). The prominence of foreign ownership means that themes of enterprise finance or corporate governance, or the ‘specific institutional advantages’, are of much less relevance and need not be well developed in the transition economy: those issues are resolved by the MNCs in their home bases.

The MNCs were attracted to countries with which they had been in contact in the past, which had heritages of reasonably modern industry, good physical infrastructures and links to western Europe. Policies could influence such

‘structural advantages’ to the extent that they helped maintain industrial bases in the sectors that attracted investors seeking acquisitions (cf. Greskovits 2005, 117-119; Kurth 1979, 3-4). Political stability was important to companies undertaking long-term investment and the likelihood of EU accession served as a useful stamp of approval.

The MNCs needed a secure legal and business environment, giving confidence that contracts would be honoured. Specific policies mattered and MNCs were sought out by governments, offering help with infrastructure development, subsidies and other concessions. There therefore had to be a stable state and also one with an agenda for supporting this form of economic development. MNCs were attracted first to the Visegrad Four countries, giving those countries further ‘structural advantages’ that became increasingly permanent.

The second form is integration through exports in complex sectors without reliance on FDI. This is a sort of residual category, with only two significant partial exceptions to setting integration through MNCs as absolute requirements for integration through exports of machinery-complex products. In the CIS, Belarus was able to export vehicles on the basis of an ‘order state’ (Iwasaki 2004), with state ownership of key enterprises and state direction of banks’ lending policies.

However, these products were able to compete only in less demanding markets and it remains to be seen whether that model will prove to be more than transient. In Eastern Europe, only Slovenia was able to take advantage of its inherited industrial structure to develop an export economy that is less reliant on FDI than is common in the region.

The third form is integration through exports in simple manufacturing – such as garments, footwear and simpler components – typically with very precise specifications as to what was required, and in some cases direct investment. There also had to be an adequate transport and communications infrastructure, but required skill levels were low – all product development took place in a richer country – so that low labour costs were a key attraction. The inherited industrial structure was also important, as it typically provided the productive capacity and labour force that could be adapted quickly to satisfy new orders. Issues of corporate governance or privatisation policies were of little significance to the foreign company, but the MNC did require a sufficiently secure legal framework to ensure that contracts would be honoured. This form of integration was important in the Visegrad Four in the early 1990s and in Southern and Eastern Europe and the Baltic States in later years. It also spread to lower income countries, including Central Asian Republics, but on a very small scale.

Fourth, integration through commodity exports played some role across many more countries, but was most important for the oil-exporting countries and for Ukraine, a steel-exporter. Exporting raw materials and semi-manufactures required a less sophisticated business environment. This was compati-



ble with lower levels of state capacity and with institutional environments that did not provide a basis for secure links between enterprises, and even less for the development of new and innovative firms.

The fifth mode of integration is the ‘financialized’ growth in which foreign borrowing supports private sector activity. Financial inflows thus fuel domestic consumption, stimulating imports and covering the deficits on many countries’ current accounts. This was never the only form of integration, but it became important as a driver for economic development in the years up to 2008 as to warrant specific attention.

Table 2: Diversity of current account financing

	Financial account, total			Financial account without FDI		
	2002	2006	2007	2002	2006	2007
Czech Rep	14.1	3.0	2.8	3.1	0.1	-1.7
Hungary	3.9	10.7	7.3	-0.2	9.7	3.9
Poland	3.6	3.8	9.4	1.7	0.7	5.1
Slovakia	15.1	1.7	8.4	3.3	-3.8	4.8
Slovenia	9.1	-0.3	5.7	2.2	0.3	5.9
Bulgaria	22.5	28.1	47.1	16.9	4.2	18.2
Estonia	10.3	18.1	16.7	8.2	14.0	11.4
Latvia	7.4	30.8	24.6	4.7	23.3	17.9
Lithuania	7.4	15.5	16.1	2.5	10.3	12.5
Romania	8.9	15.4	17.7	6.4	6.5	11.8
Albania	4.8	5.8	6.8	1.8	2.3	2.6
Bosnia & Herzegovina	8.9	10.1	14.4	4.6	4.3	0.6
Croatia	10.3	13.1	11.2	8.2	6.6	3.2
Macedonia	6.6	6.8	6.0	3.8	0.2	1.9
Serbia			18.8			21.1
Belarus	5.2	4.6	11.6	2.1	3.6	7.7
Kazakhstan	5.5	20.0	8.0	-3.3	11.7	0.4
Russia	0.6	0.3	7.4	0.8	-0.4	6.7
Ukraine	-2.5	3.6	10.7	-4.2	-1.7	4.2
Armenia	6.2	6.8	10.7	1.5	-0.2	3.3
Georgia	0.4	17.3	21.6	-4.2	3.5	5.3
Kyrgyzstan	6.9	11.9	9.3	6.6	5.5	3.8
Moldova	1.2	10.5	22.2	-3.8	3.2	11.2
Tajikistan	6.0	9.8	21.9	3.0	-2.2	12.2

Source: calculated from IMF financial statistics.

The most basic indicator for financialized growth is the surplus on the financial account excluding the contribution of FDI. Table 2 shows the breakdown by countries. The group of financialized economies spreads across geo-

graphical areas and is not obviously linked to export structures, economic levels or previous transformation strategies. This includes Hungary, Belarus, Ukraine and Kazakhstan.

A number of low income countries also depended significantly on financial inflows, including Armenia, Georgia, Tajikistan and Kyrgyzstan, but much of this came in the form of official aid with rather different implications for economic development. Russia was unique among countries with a significant financial inflow, as it also achieved substantial current account surpluses, meaning that it was building up reserves at the same time.

Prerequisites for financialized growth include both internal and external conditions, covering the availability of liquidity, bankers' perceptions of the countries concerned, activities to which they could give loans and an internal environment that meant the domestic economy could not provide enough credit without inflows from outside. Inflows clearly escalated into Baltic Republics and South-East European countries around the time of EU accession. None of these countries saw dangers in the process and governments actively encouraged the inflow. Thus, fixed exchange rates guaranteeing macro-economic restriction and real exchange rate appreciation, capital account liberalization, and light-to-no-touch regulation of lending, and low-to-zero taxation on capital gains (including housing market speculation) were associated with financialized development.

Hungary was somewhat exceptional in that part of the inflow financed state budget deficits. Portions also went to businesses and households (see Table 3). The government, in fact, originally encouraged mortgages, but the subsidies were cut in 2003 (Rózsavölgyi and Kovács 2005). At that point, the middle-class demand for low-interest credit was satisfied by foreign-currency mortgages offered by transnational banks (Bohle 2009). This latter phenomenon was new to the 2000s, with much of the credit being applied for house purchases, in comparison to the 1990s in which credit had gone overwhelmingly to enterprises.

Finally, the sixth form of international integration is dependence on remittances, aid and borrowing from IFIs to compensate for often substantial trade deficits.

These were common methods for the lowest income countries. The enterprise sphere failed to provide competitive exports and also to compete with imports.

Integration into the world economy took place, therefore, in the form of citizens working in other countries, often Russia and in some cases central or western Europe, and sending earnings home.

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Table 3: Domestic credit

	Domestic Credit (percentage of GDP)			Loan/ Deposit Ratio	Domestic Credit to Households (percentage of GDP)		... of that mortgages	
	2000	2007	2008 Q1		2002	2007e	2002	2007e
Estonia	34.9	95.1	90.4	2.1	10.6	43.3	51.9	87.1
Latvia	23.3	94.8	86	2.8	7.3	42.7	56.2	78.9
Lithuania	15.2	60.2	55.7	2	2.4	24.4	79.2	70.5
Czech Rep	49.4	52.9	51.1	0.8	7.3	20	41.1	62.5
Hungary	53.5	74.4	72.9	1.4	7.4	21.7	55.4	75.6
Poland	34.4	46.6	46	1.1	9.4	20	25.5	49.5
Slovakia	56.6	51.6	48.2		5.5	16.3	18.2	27.6
Slovenia	8.9	79	-		10.5	19.2	19	32.3
Bulgaria	17.8	59.2	53.4	1.3	3.7	23	-	45.2
Romania	14	35.7	31.9	1.3	-	17.7	-	7.9
Croatia	47.2	82.9	76.6	1.1	23.8	41.1	28.6	39.9
Russia	24.7	25.2	19.5	1.3	1	9	-	21.1
Belarus	19.2	27.2	21.6	1.5*	1.8	8.3	88.9	55.4
Ukraine	37.9	48.7	44.4	2	1.6	22.5	88.9	28.9
Armenia	11.5	12.1	11.2		1.5	6.4	-	26.6
Azerbaijan	9.6	18.2	10.7		1.4	5.8	-	12.1
Georgia	21.6	31.6	29.6		3	8.8	16.7	29.5
Moldova	25.2	40.2	36.3		0.5	5.5	180	72.7
Kazakhstan	12.3	41	30.1	1.7	1.6	20.3	12.5	20.2
Kyrgyzstan	12.2	14.2	-		0.3	3.3	-	72.7

\*2007 data, Reiffeisen Research.

Source: IMF (2008b); Moody's (2008); author's calculations; (a) Data are for first quarter of 2008.

Note: Domestic credit to households is the ratio of outstanding bank credit to households, at end-of-year, to GDP; mortgage lending is the ratio of mortgage lending to households, at end-of-year, to GDP; asset share of foreign-owned banks is the share of total bank sector assets in banks with foreign ownership exceeding 50 percent, end-of-year.

## Varieties 2: Worlds of welfare

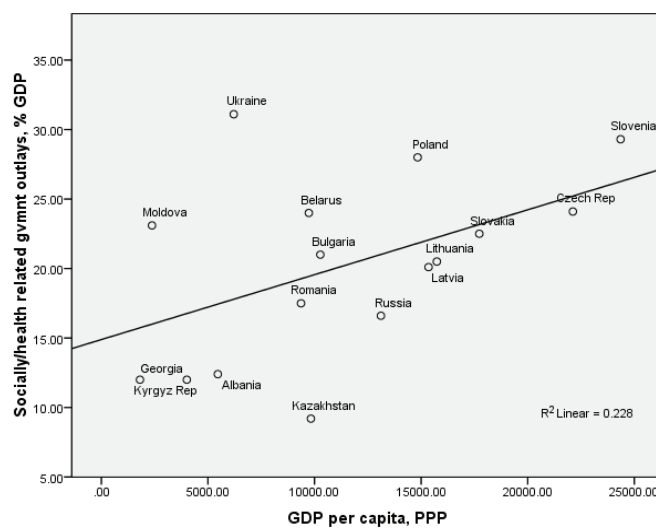
The capitalist variety outlined above was coupled with different welfare-state regimes. However, as the ‘specific institutional advantages’ including also institutions of social protection played a relatively minor role, the link between the welfare regimes and the internal preconditions constituting the growth regimes is less direct than implied in the VoC framework (cf. Ebbinghaus and Manow 2001).

The integration through complex-sectors is favourable to protective institutions as it provides higher income and involves specialization in activities that are less sensitive to labour costs. However, domestic institutions, such as those regulating industrial relations and labour markets, made little difference for MNCs in solving labour problems. Relatively generous policies could also be introduced in the context of other income-generating growth models, such as those reliant on commodity exports. This meant greater variation between countries and between firms within countries.

The main predictor of the generosity of welfare institutions, and their actual existence, was the strength of welfare constituencies within the respective political systems (Myant and Drahokoupil 2010, Chapter 10). Existence of welfare institutions was also conditioned upon state capacity to implement social policies, maintain administrative control over welfare infrastructure, and its ability to raise revenue. Effective systems of social protection were thus introduced where the executive was effectively accountable to electoral constraints, as was the case in Eastern Europe, or where the social interests were represented in the political system, as was the case particularly in Slovenia. In authoritarian regimes, the outcomes were variable. One factor, as argued by Cook (2007), may be the strength of bureaucratic-statist welfare interests in relation to the presidential power.

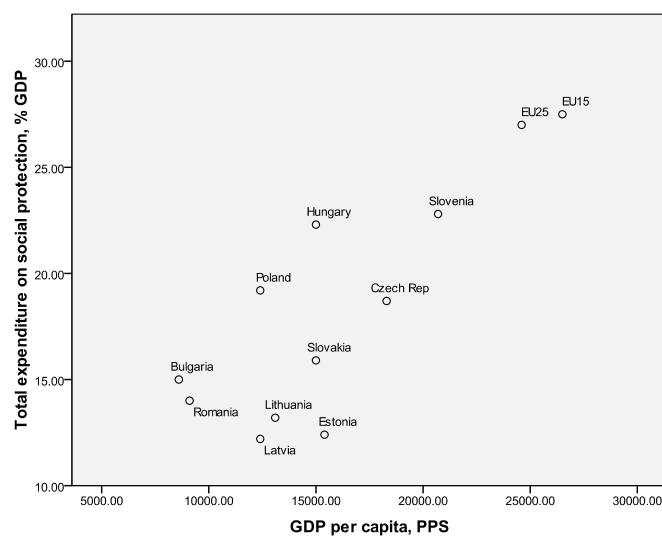
The experience from welfare-state transformation in the last two decades has shown that the political strength of welfare constituencies also conditions reactions to fiscal shocks and economic crisis. These shocks may lead to significant welfare retrenchment in the short term, but the mid-to-long term implications of such shocks are likely to be conditioned by political rather than economic factors. Most notably, such was the experience in Hungary in the aftermath of the crisis in the mid 1990s (see, e.g., Inglot 2008, 277-294). In fact, political factors – rather than economic constraints – were responsible for the most dramatic welfare retrenchment, that undertaken in Slovakia (O’Dwyer and Kovalčík 2007; Fisher, Gould, and Haughton 2007).

Figure 1: Social and health related government outlays, % of GDP



Source: International Monetary Fund (2007) Government Finance Statistics Yearbook.

Figure 2: Total social expenditure on social protection in Eastern Europe, % of GDP



Source: Eurostat, available at [eurostat.ec.europa.eu](http://eurostat.ec.europa.eu).

Figure 1 and Figure 2 provide key indicators of welfare efforts. As would be expected, these were largely conditioned by the level of development (measured here as per capita GDP in purchasing power parity). Yet, even when controlling for GDP levels, there is great variation reflecting policy choices. Relatively high levels of spending in Ukraine and Hungary, for which comparable data were not available and can thus be found in Figure 2 only, reflect the electoral importance of welfare constituencies that has shaped the nature of welfare-state adjustments (cf. Mykhnenko 2009; Tóth 2009). This is reflected in high levels of pensions relative to average pay. Other countries above the trend line followed slightly different courses of development. Belarus sustained relatively high spending levels, but institutional reforms to address new problems such as unemployment were lacking. Poland had the experience of high pension payments from the early 1990s, possibly to satisfy, and later defended by, a powerful labour lobby. Slovenia moved close to the 'European' social model with its higher levels of spending and provision.

Countries below the trend line include Kazakhstan, a case of an authoritarian regime that minimised scope for interest representation and in which decisions could be made without much external scrutiny. The power of welfare constituencies to influence the government in Russia was also weak, but sustaining the existing levels of social provision became an important political issue in the 2000s; and governments seem to be determined not to allow decreases in social spending. The weakness of state capacity in these and other CIS countries meant that formal commitments to levels of provision need not be reflected in reality.

It is therefore possible to characterise welfare regimes in former state socialist countries around three ideal types, each of which is in a process of evolution and influenced by conflicting pressures for change<sup>3</sup>. For Eastern European states, the classification broadly corresponds to the three types of capitalism in Bohle and Greskovits (2007). However, we prefer a less encompassing perspective with more variation within country groups.

The first is the 'informalized' model. The state does not provide the social protection that the population implicitly demands. It may have legal obligations to do so, but fails to honour them. Improvised solutions are then found by enterprises and individuals, who make informal payments for what may formally be publicly-provided services. Russia has roughly fit this ideal type and its evolution has been towards a system of low formal provision coupled with a formalised need to pay for much of welfare provision (cf. Davidova and Manning 2009). Enterprises remained major providers of social services, including health care and housing: in 2008, there were still 460 mono-industrial, one-company towns with a total population of 25 million (Malle 2009, 259). Remit-

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<sup>3</sup> For detailed discussion, see (Myant and Drahokoupil 2010 Chapter 10).

tances constituted an important source of income particularly in low income CIS countries. Some of the countries approximating the 'informalized' model recorded relatively high social spending (e.g. Ukraine and Moldova), but this went to pension and public sector wages, squeezing spending on services. Out-of-pocket payments, both formal and informal, thus constitute a major source of financing for health care (Shishkin et al. 2003; Lewis 2000).

The second is the 'minimal welfare state' model, in which there is greater formal dependence on private provision and payment for services than is usual in western Europe. The state and its welfare institutions went through adjustments. Therefore, unlike in the informalized model, the state fulfils its formal obligations and ensures that a private sector can supplement its activities to provide what is considered an adequate level of provision. This roughly corresponds to countries that underwent gradual welfare-state adjustments with low levels of overall provision, including the Baltic States and South-Eastern Europe. The 'minimal welfare state' also corresponds to Slovakia, which underwent neoliberal restructuring after 2002.

Opposition to retrenchment was relatively strong there, as this is a country with significant interest representation; and other Central European countries have not as yet followed the same route. Further development could be either towards the 'European' social model or could continue along the current route.

The third is the 'European' social model, as advocated especially by the social-democrat oriented political forces in Central Europe. The nearest example is Slovenia with considerable applicability in other Central European states. However, it is clearly under threat, with pressures for reductions in tax levels and welfare provision. Corporatist, status maintaining, social insurance constituted the underlying principles of core welfare institutions in such welfare states. In many cases, social insurance programmes provided universal coverage, with the contributions for those from outside of the labour force paid from the state budget.

However, a large part of welfare arrangements in Eastern Europe is residual in its effects (Aidukaite 2006; Sirovátka and Saxonberg 2008; Keune 2009). Low ceilings make earnings-related benefits effectively flat and unattractive for middle classes.

At the same time, social transfers had an important redistributive role in the Czech Republic, Slovenia, and Hungary. Thus, with considerable variation, these states combine elements of different welfare-state models known from the West (cf. Esping-Andersen 1990), but the level of social spending is much lower, making much of the provision residual.

### Varieties 3: Vulnerabilities and the crisis

The variety of developmental models and the differences in public spending was associated with a variety of vulnerabilities, making some countries better

prepared to cope with the crisis than others. In general, countries were with financialized growth, where private sector borrowing fuels domestic consumption and asset price bubbles were most vulnerable, but there was a large scope of variation, depending on the specific policies pursued. Public sector borrowing played a marginal role in the majority cases, but it represented a very important factor in Hungary. Low domestic savings pools and interest rate differentials encouraged borrowing abroad, creating debt refinancing risks. The dependence on capital imports was linked to foreign-currency indebtedness and fixed exchange rate arrangements, which represented important constraints for adjustment to economic shocks. The highest degree of currency substitution was also important in other growth models with high interest rate differentials and poor regulation of finance.

The structure of vulnerabilities depended on the balance-sheet situation of the main economic actors, in particular on the maturity, capital, and currency structure of their assets and liabilities (Roubini and Setser 2004; Connolly 2009)<sup>4</sup>. Aggregate balance sheet data are presented in Tables 3-6. The actual vulnerabilities as distributed among main actors were revealed as the crisis hit the region. The complexity of its effects can be analyzed along a four-stage framework. The first stage was the ‘credit crunch’, the crisis in banks caused by unsound lending to households. The second stage, the ‘demand slump’, was an extension of financial crisis into reduced demand for products that were dependent on credit, especially purchase of housing, construction, motor vehicles and other consumer durables. The third stage consists of the adjustments to the new economic environment and patterns of international capital flows. This is much more varied in form. The fourth stage, the ‘solvency crisis’, could hit when governments, having run deficits during economic depression and warding off the effects of the preceding stages, are no longer able to borrow to cover those deficits, or at least when the cost of borrowing presents them with a major problem. In some countries the stages are easily separable and follow in sequence. In others the separation is less clear.

### Stage 1: The credit crunch

The credit crisis hit countries where the private sector actors and/or governments needed to raise capital to refinance their debt. The drying up of global liquidity led to major problems in the financialized regimes where persistent current account deficits were financed by foreign credits. In such a context, the

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<sup>4</sup> Capital structure mismatch refers to structural vulnerabilities resulting from excessive dependence on debt financing rather than equity. Currency mismatches occur if the currencies in which debts are denominated differ from the currency of assets held or revenues earned by different sectors within the economy. Maturity mismatch arises if short term liabilities are not covered by reserves or revenues (short-term assets), putting the country into a solvency risk in the case of financial crisis.



drop in financial inflows translated into a contraction of domestic consumer demand and a collapse of real-estate prices and thus the construction sector. GDP in the financialized economies was therefore already falling in the last quarter of 2008. As shown in Table 7, the greatest output contractions were initially experienced in Latvia, Ukraine, and Estonia. What is more, refinancing problems led a number of countries to seek emergency financing from the IMF and, in the CIS context, from Russia.

This gave the IMF significant power through its conditionalities (discussed below) and gave Russia geopolitical leverage.

The credit crunch led to a capital flight from the region, triggering devaluations in countries pursuing floating exchange-rate arrangements. Among those hit the most, the national currency lost between October 2008 and March 2009 about 50 percent of its value in Ukraine, 30 percent in Poland, 25 percent in Russia, and more than 20 percent in Hungary. This was particularly painful in countries with high shares of foreign currency loans (see Table 6). This also increased difficulties in debt refinancing there. Cumulative losses to non-bank enterprises, households, and the government from devaluation between October 2008 and March 2009 amounted to 18 percent of GDP in Hungary and 8 percent in Poland (Auer and Wehrmüller 2009). Slovakia and Slovenia had adopted Euro and were protected from devaluation shocks, but suffered from the decrease of cost-competitiveness due to the significant appreciation relative to their competitors in Eastern Europe.

There was a chance element that provoked crisis within countries in the inability to repay debts at a particular time. The pattern of debt maturities could mean that it could hit a country with a relatively low debt level, as was the case in Belarus.

Table 4 provides an overview of the maturity imbalances and thus helps to identify countries with refinancing needs. These are aggregate figures and the actual problems reflected the balance sheet situations of individual actors rather than economies as a whole. What is more, the currency structure of assets and liabilities also played an important role.

A more complete picture can thus be obtained through a comparison with the levels of indebtedness of individual sectors (Table 3), the extent of foreign currency loans (Table 6), and external indebtedness (Table 5). Solvency problems in Ukraine, Hungary, and Latvia forced these countries to seek help within the IMF's Stand-By Arrangement in late 2008. Russia appeared to be in a very sound position, given the size of its state reserves accumulated during the oil boom. The Russian state could thus act as a source of emergency financing for other CIS states. The credit crunch, however, represented a major problem for the private sector that relied extensively on foreign financing. As indicated, in Table 3, the level of indebtedness of the Russian private sector was not high in relative terms, but refinancing of its short-term liabilities represented a major problem, as the prices of shares often used as collateral plum-

meted in the context of the falling price of oil (Malle 2009, 258). State reserves could thus be used to solve the liquidity problems in the private sector, leading to further subordination of the private sector to the state.

Table 4: Solvency risks and maturity structures

	External debt/exports, %	FX-reserves- to-ext debt		S-t-to-FX- reserves, %		Debt refinanc- ing needs, % of reserves
	2008	2000	2008	o. mat	r. mat	2009
Poland	133.9	0.38	0.27	84	124	141
Czech Republic		0.6	0.42	88	113	89
Slovakia	67.0	0.37	0.34	111	137	
Hungary	138.7	0.36	0.19	99	177	101
Slovenia	147.6	0.26	-			
Lithuania	113.5	0.27	0.21	111	159	204
Estonia	151.7	0.31	0.17	284	358	346
Latvia	298.0	0.18	0.16	246	312	331
Croatia	214.5	0.3	0.28	40	87	136
Bulgaria	168.8	0.27	0.44	89	112	132
Romania	136.1	0.22	0.35	63	89	127
Serbia	204.9					
Albania	73.9					
Montenegro	29.7					
Bosnia & Herzegovina	113.5					
FYR Macedonia	102.4					
Belarus	39.7	0.28	0.24	155	170	150+
Russia	118.5	0.15	0.86	18	29	34
Ukraine	120.6	0.09	0.24	79	110	117
Moldova	165.3	0.13	0.38			
Georgia	127.7	0.07	-			
Armenia '07	123.8	0.33	0.42			
Azerbaijan	20.2	0.64	0.67			
Kazakhstan	138.8	0.13	0.2	23	52	82
Kyrgyzstan	73.7	0.13	-			
Tajikistan	274.6					
Uzbekistan	32.1					
Turkmenistan '06	10.7					

Source: IMF (2008b); Moody's (2008); EBRD (2008), in Conolly 2009.

S-t-to-FX-reserves: Raiffeisen Research and central banks.

External Debt Refinancing Needs (IMF).

Table 5: External debt and its structure, %GDP

	2008	2008.q3				
	total EBRD	total	gvmnt	Total private	banks	Other sectors
Poland	46.0	39.5	15.1	24.5	10.9	13.6
Czech Republic		36.2	8.7	27.5	12.8	14.8
Slovakia	53.3	42.7	11.5	31.2	18.9	12.3
Hungary	113.5	87.4	32.6	54.8	38.1	16.7
Slovenia	101.1	84	10	73.9	49.3	24.7
Lithuania	68.7	65	9.9	55.2	37.2	17.9
Estonia	115.7	94.7	2.9	91.9	64.3	27.6
Latvia	124.2	118.3	6.2	112.1	84.9	27.2
Croatia	82.7	77.4	17	60.5	19.6	40.9
Bulgaria	103.5	71.4	8.3	63.1	27.1	36
Romania	35.4					
Serbia	60.6					
Albania	20.4					
Montenegro	15.1					
Bosnia & Herzegovina	43.6					
FYR Macedonia	49.1					
Belarus	24.6	24	3.9	20.1	5.6	14.5
Russia	36.0 (2007)	31.6	2.1	29.5	12.5	17.1
Ukraine	57.3	59.9	8.4	51.5	25.1	26.4
Moldova	68.2					
Georgia	35.6					
Armenia '07	23.3					
Azerbaijan	13.8					
Kazakhstan	79.8					
Kyrgyzstan	45.7					
Tajikistan	43.5					
Uzbekistan	13.6					
Turkmenistan '06	7.7					

Source: OTP Bank Hungary, EBRD.

Table 6: Loans in foreign currency, % of loans

	Loans in foreign currency (% of total loans)				FX gov debt
	2003	2006	2007	2008 IMF	2008f
Estonia			80	85.3	49.7
Latvia		70*	80+**	89.3	64.2
Lithuania			50+	64	70.5
Czech Rep	13.5	13.6	13	13.6	11
Hungary	25	43.6	52.4	65.7	37
Poland	30.3	27.1	24.4	32.6	36
Slovakia	20.3	22	23.6		37.1
Slovenia	25.6	55.4	9.6		
Bulgaria	43.6	45.7	62.2	66.9	72.7
Romania	45	47.3	54.3	55.5	48.3
Croatia	10.1	9.9	8.6	62	63
Serbia	37.9	12	8	68	
Albania			70		
Russia	33.8	28.7	25.2	15.3	46.5
Belarus	50.4	33.8	41.5		45.6
Ukraine	41.7	49.5	49.9		91.7
Georgia			60+		18.3
Kazakhstan	55.5	48.4	42.7	43.6	

Source: Raiffeisen Research (2008), EBRD (2008) estimates in italics.

\* wiiw Monthly Report No. 4/2007, \*\* Fitch Ratings FX gov. debt: Moody's (2008, pp. 92-98), IMF estimate.

Table 7: Falls in exports and GDP contractions in 2008-2009

	Change in exports y-o-y*			GDP 2009		
	Exports as % of GDP in 2008	2009 Q1	2009 Q2	2008 Q4	2009 Q1	2009 Q2
Czech Republic	67.1	-19.0	-19.4	0	-4.4	-5.8
Hungary	68.8	-16.0	-13.5	-2.5	-6.7	-7.5
Poland	33.9	-2.4	-2.9	2.9	0.8	1.1
Slovakia	75.8	-29.6	-27.0	2.4	-5.7	-5.4
Slovenia	53.7	-22.4	-23.7	-0.8	-8.3	-9.3
Estonia	53.5	-25.9	-27.8	-9.2	-15	-16.1
Latvia	28.4	-25.7	-27.4	-10.3	-18	-18.7
Lithuania	50.2	-24.9	-36.1	-2.2	-13.3	-20.2
Bulgaria		-26.9	-33.4	3.5	-3.5	-4.9
Romania	24.5	-7.4	-9.3	-6.6**	-13**	-8.2**
Croatia		-13.4	-23.9			
Bosnia & Herze- govina		-20.7	-26.3	12	-10.9	-9.9
FYR Macedonia		-34.6	-33.2	-0.8**	-10.8**	-13.2**
Montenegro		-22.5	-58.2		-15.9**	-28**
Serbia	21.6	-13.5	-9.9	2.8	-4.2	-4
Albania		-13.5	-20.1			
Ukraine	37.5	-39.4	-51.5	-8	-20.3	-18
Belarus	61.0	-48.9	-46.4			
Uzbekistan		6.1	-6.3	7.8	7.9	8.5
Mongolia		-44.4				
Russia	28.1	-47.9	-46.3	1.2	-9.8	-10.9
Azerbaijan	66.0	-50.4	-47.4	10.8	4.1	3.6
Kazakhstan	53.0	-49.2	-52.5	0.8	-2.2	
Turkmenistan	n/a					
Armenia	9.2	-47.3	-44.8			
Georgia	18.8	-53.1	16.4***	-2.5		
Kyrgyzstan	35.3	-9.8	-10.9			
Moldova	27.1	-17.8	-22.9			
Tajikistan	8.5	-48.3	-47.6			

\*Changes in exports measured in local currencies in Eastern European countries and in USD in the CIS. This overestimates the decline in CIS as the USD appreciated by approximately 20% related to ruble.

\*\* Industrial production.

\*\*\* preliminary.

However, in general, countries in trouble were ones with long histories of accumulating international debt, meaning that they had failed to build an export potential to finance growth in domestic consumption, and with banking systems that consistently failed to match the growth in credits by a growth in deposits. In hindsight, figures showed weaknesses of the financialized development very clearly, but were not taken seriously enough in the years before 2008 to force changes in policies (despite warnings such as Becker and Weissenbacher 2007; Berglöf 2007).

### The Role of the IMF

Solvency problems led a number of countries in the region to seek help from the IMF, with Georgia, Ukraine, Hungary, Kyrgyzstan, Latvia, Belarus, Serbia, Armenia, Mongolia, Tajikistan, Romania, Poland, and Bosnia and Herzegovina enrolling in some of IMF lending programmes between September 2008 and September 2009. In the EU member states and accession countries, the EU commission had an important role in shaping these programmes and in providing funding. IMF's stand-by-arrangements, such as those implemented in transition economies in the 1990s, had been associated with one-size-fit-all conditionalities placing emphasis on macroeconomic restriction, often enforcing cuts in public spending. The IMF, however, claimed to have changed its approach in the context of the global financial crisis, overhauling its general lending framework to become more flexible and tailoring loan terms to suit country needs as well as putting emphasis on social protection to protect the most vulnerable through the social safety net and streamlining loan conditions with more flexibility on fiscal policy and inflation (IMF 2009a, 2009b). The IMF became a strong supporter of government fiscal stimuli and expansionary monetary policies implemented in the EU and the US to counter-act the world recession (IMF 2008a). It also introduced a new lending instrument, the conditionality-free and unphased Flexible Credit Line for 'well-run emerging market economies' (IMF 2009a, 1), which was extended to Poland.

In the transition economies, the actual experience was more complicated. It may be possible to speak about a new approach to emergency lending in low-income countries. In this context, agreements seemed to be indeed less biased to pro-cyclical policies, with agreements in Georgia, Kyrgyzstan, and Armenia including expansionary fiscal policies. What is more, improving the social safety net and defending or increasing social spending plays an important role in such agreements.

These were the 'informalized welfare models', which had failed to adjust their welfare-states. IMF and WB intervention thus may play an important role in pushing for making social policy matter.

The IMF agreements in East European countries, nevertheless, did not show signs of a major change in IMF's approach, with conditionalities putting em-

phasis on fiscal and monetary restriction (cf. IMF 2009c; Weisbrot et al. 2009). Ukraine, for instance, agreed that the budget deficit, excluding bank recapitalization costs, would not exceed 1 percent of GDP in 2008 and 0 percent in 2009. Hungary vowed to reduce the public sector by 2.5 percent of GDP and introduce a rules-based fiscal framework. This was particularly harsh, as the government had undertaken budget cuts reducing deficit from 10 to 3 percent of GDP in the previous two years. As in Ukraine, cuts in spending took place in the context of pro-cyclical monetary tightening. In April 2009, signs of flexibility were observed with the IMF and the EU agreeing to lift the deficit target to 3.9 percent of GDP.

The implications of IMF conditionalities may be most profound in Belarus, as they put emphasis on important structural reforms, including price liberalization, cutting price subsidies, and scaling down subsidies and direct lending for enterprises. As far as welfare policies are concerned, Belarus also did little to adjust them to the new environment, but it continued supporting old means of welfare provision such as utility and housing subsidies. IMF would like to see those policies scaled down and replaced by the targeted safety net. This may enforce some needed adjustments in social policies. At the same time, the conditionalities require dismantling policies such as utility subsidies that constituted the core of the Belarussian welfare system.

However, the role of the IMF should not be over-estimated. First, the IMF's intervention was associated with other factors militating against anti-cyclical measures, such as higher initial debt levels. The IMF's intervention thus did not necessarily lead to a more restrictive policy. At the same time, however, its funding did not provide leeway for counter-cyclical anti-crisis measures as would be preferred by some of the IMF's critics (e.g. Weisbrot et al. 2009). Second, policy makers in countries as varied as Belarus, Latvia, and Serbia seemed to prefer restrictive policies for reasons other than the IMF's conditionalities. Finally, there is a question of the degree of enforceability as far as the IMF's conditionalities are concerned. This is particularly relevant for the CIS countries where Russia seemed to be willing to provide alternative sources of financing. What is more, the IMF did not seem to be willing to go as far as to let countries default to enforce the conditionalities, particularly if that would imply a collapse of a government deemed allied to the West. The latter was the case of Yulia Tymoshenko government in Ukraine. Thus, in the context of the run up to February 2010 elections, the IMF continued to support the government despite its clear failure to meet conditionalities on fiscal restriction in 2009 and also in the 2010 budget.

The interventions of the IMF and the WB had been previously associated with pressures for institutional reform of the welfare states with long-term impact, most notably pension-system reform (Orenstein, 2008). This time, the pressure for further privatization does not seem to be a priority. The stage 1 of the crisis had an immediate negative impact on privatized pension schemes.

Portfolios of mandatory private individual accounts that had been introduced through the WB-inspired reforms recorded substantial year-on-year losses: 30.5 percent in Estonia (15 Oct 2008), 35 percent Hungary (15 Oct 2008), 48.4 percent in Lithuania (15 Oct 2008), and 12.4 percent in Slovakia (15 Oct 2008) (WB 2008b). This did not provide a case for further reform, nor did it lead to a change in WB's thinking (2008b).

### Stage 2: The demand slump

The second stage refers to the impact of falling demand for physical goods following the first effects of the financial crisis. That impact was felt on domestic demand for exports, hitting particularly countries with a high share of exports relative to GDP (see Table 7). This included some countries already suffering from Stage 1, such as Hungary, Ukraine and the Baltic States, and some that appeared to have escaped without much effect, including Slovakia, and the Czech Republic.

A division can be made into countries with exports based on manufacturing and light industry, largely Eastern Europe, and countries exporting semi-manufactures and raw materials, including Russia and Ukraine. Falls in exports and GDP are indicated in Table 7. Eastern European countries recorded lower drops in exports than the natural-resources exporters in the CIS. The export falls among the manufacturing exporters reflected the drop in the volume of goods exported, which immediately translated into a collapse of industrial output and thus of GDP. In contrast, the falls in exports among the natural-resources exporters led to a collapse in export prices rather than volumes. The impact on output (measured in constant prices as GDP) was thus less severe and immediate.

Moreover, the initial drop in manufacturing demand in Eastern Europe was ameliorated by the expansionary policies pursued in Western Europe (and also in Slovakia). The German car scrap scheme, in operation until September 2009, was particularly important for export demand in the Czech Republic and Romania, which produced smaller and cheaper cars popular in this context. Poland's GDP was the least dependent on exports and also the least dependent on exports from the motor-vehicle industry. Slovakia appeared the most vulnerable should this sector suffer.

The second stage is less clearly differentiated. Drops in output shown in Table 7 were also related to the collapse in financialized growths, which span the usual groupings of transition economies. Russia was hit by the sharp fall in commodity prices, but that tied in more closely with the financial effects covered under the third stage. The reason for this difference was that key enterprises were under domestic rather than foreign ownership. This gave them a financial independence that was absent for the big firms, or rather subsidiaries



of MNCs, in CEECs. At the same time, Russian firms had to raise finance in ways that carried risks for the domestic economy.

### Stage 3: Adjustments to the new environment

The third stage brought some further threats that operated through international, as well as internal, economic processes. The new international economic environment implied adjustments in national economic structures and, most notably, in the ways of achieving external balance. The collapse of import demand based on external borrowing resolved the current account problems of financialized economies. In contrast, current account started to be an issue among the natural-resource exporters, which have seen their export earnings reduced by the collapse of prices.

There are also further dangers to countries that had been dependent on financial inflows and that had a significant share of credits in foreign currencies. The drop in real-estate prices put a strain on balance sheets of the private sector, with the increase in the stock of non-performing loans undermining the banking system. Any currency devaluation then threatens the ability of debtors to repay, in turn threatening the stability of creditor institutions. This provides incentives to the governments to defend the exchange rate through pro-cyclical policies rather than to compensate for the falls in the level of economic output through expansionary policies.

The adjustment was thus particularly socially costly in the Baltic States, which attempted to defend their fixed exchange rate arrangements through public spending and wages cuts. In June 2009 Latvia, the worst hit, implemented €712m in spending cuts and tax increases, designed to reduce the budget deficit by 10 percent of GDP in the next three to four years. It cut wages in the public sector by almost 40 percent and reduced pensions by 10 percent. It also reduced benefits and increased payments in health care. The Baltic States seemed to reach a dead end in their growth strategies as the speculative boom is not likely to be repeated in the region in the foreseeable future.

The third stage had only a gradual impact in CEECs. Domestic demand levels fell as external finance was reduced and as output – and hence wages and employment – were reduced in export-oriented activities. However, that did not lead to further financial difficulties, for example due to failure to repay loans to banks.

Some banks have seen their credit ratings downgraded, reflecting the difficulties for their customers in the context of collapsing demand. Foreign-owned banks in CEECs were perceived as prudent as they did not buy into subprime markets.

However, in countries with low deposit bases (see Table 4), concerns were raised about the lack of liquidity and capital. Moreover, the scarcity of capital

provided mother-banks incentives to withdraw funds from the region (EC 2009, 22).

Following intensive lobbying by banks with exposure to CEECs markets, the Joint IFI Action Plan for Central & Eastern Europe (including the EBRD, the EIB Group, and the World Bank) was launched in March 2009 to address these concerns. It pledged to provide up to €24.5 billion of support to the banking sectors in the region and to fund lending to businesses. Credits were reduced gradually, reflecting greater caution from banks; and difficulties with credits in foreign currency were generally overcome by increasing payments from debtors. The third stage therefore meant lower living standards for the population, lower tax revenues for the state and subsequent growing budget deficits, but no immediate further downturn. The effects on the trade balance remained unclear, as lower domestic demand cut imports while lower export demand cut exports, with no certainty as to which reduction would be the larger.

An open question remains the fate and behaviour of MNCs, which might rethink their strategies towards investment in CEECs. Reduction in inward investment, and more dramatically decisions to pull out, would lead to lower employment and domestic incomes as well as lower export levels and lower levels of financial inflow, which had helped to balance out current account deficits. Multinational companies could become a net drain as repatriated profits dominate over capital inflows and benefits from net export earnings. All of this is possible, but it is also possible that MNCs would see CEECs among their most desirable locations, as they continually offer cheaper labour than in western Europe. The first quarter of 2009, however, recorded a drop of one-third in new FDI projects in most of East-European countries<sup>5</sup>.

A heavy blow was also felt in countries dependent on remittances when production, and hence demand for labour, fell in the countries where those people had previously worked. The countries most dependent on remittances, set out in Table 1, included a number of smaller CIS countries and Albania. They can be expected to suffer very severe falls in income levels. Based on the experience of the 1998 Russian Crisis, O'Hara, Ivlevs, and Gentile (2009) suggested that by 2012, remittances to the region could fall to only one-third the 2008 level, and that a return to pre-crisis levels of remittances could take almost a decade.

#### Stage 4: The solvency crisis

The fourth stage, the crisis in state budgets as a result of the effects of the world financial crisis, remained a permanent threat limiting governments' scope for active intervention. The region started from a good position in terms

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<sup>5</sup> Country reports at [fdimarkets.com](http://fdimarkets.com) (accessed 1 June 2009).

of its public indebtedness. However, in the aftermath of the crisis, the transition economies have seen their revenues fall faster than the rate of GDP contraction, with the difference being attributed to the falls in imports, the declining asset base, weak compliance, and – in some cases – tax reductions. This led to budget deficit increases and put public spending cuts on the agendas. What is more, the crisis of financialized growth led to an increase in public borrowing to recapitalize banks and underwrite subprime loans. State default became an immediate threat in Latvia, which was dependent on EU and IMF lending but struggled to fulfil their conditionalities.

### Conclusion: Immediate impacts, long term prospects

The 2008 financial meltdown triggered a crisis *of* the capitalist varieties that relied primarily on the financialized growth. In such contexts, the challenge is to restructure economies around the productive sectors. Financialization was associated with foreign-currency indebtedness and fixed exchange rate arrangements. This created important policy incentives to defend the value of currency rather than output and employment, channeling adjustments through public spending and wage cuts. The level of financialization was highest in the Baltic States. There, the potential of productive sectors in these countries is very weak. With policy options limited by economic and political constraints, the risk of social and economic disintegration along with continuing depopulation is thus high. These states face a profound political crisis, potentially undermining political arrangements underpinning their ‘minimalist’ welfare states. The search for an alternative may thus also involve transformation of their welfare model. The rescue package in Latvia included not only massive spending cuts in the defence of the present economic model, but also scrapping of the flat tax, the symbol of the Baltic model.

The global meltdown was a crisis *in* (rather than a crisis *of*) the developmental models based on natural-resource exports, with contractions reflecting decline in values rather than that of the actual output. Moreover, high reserves allowed the Russian state to conduct counter-cyclical policies and bail out the private sector companies facing insolvency. Crisis led to a significant fall in incomes also in the remittance – and aid-dependent economies. However, in some low-income countries IMF assistance may lead to an improvement in their ‘informalized’ welfare models.

The prospects in the countries dependent on foreign direct investment and exports into Western markets remain an open question. Downward adjustments in global FDI flows and import demand may lead to a crisis *of* this model, with FDI becoming a net drain on the current account rather than the primary source of its financing. But the ‘crisis *in* scenario’ is also possible: the region can become a desirable low-labour-cost location in the context of the productive capacity restructuring pending in Europe. The capacity of these countries to

sustain their levels of social spending in the post-2008 adjustments remains to be seen. It can be expected that there will be strong political pressures in these countries to sustain (or go back to) higher levels of provision in the future. The feasibility of such adjustments, however, will be conditional upon early economic recovery.

Ultimately, indeed, the prospects of the region depend on the developments in the world economy. The IMF predictions point to a relatively limited period of economic decline but are accompanied by warnings that the area of uncertainty is large as well as that there could be a more prolonged and severe depression with more serious consequences for individual countries. A major reason for pessimism is the observation that previous financial crises in individual countries have tended to be long lasting with recovery dependent on strong demand from outside, in other words from the rest of the world (IMF 2009d; see also Reinhart and Rogoff 2008).

Levels of credit have tended to recover very slowly. Experience in transition economies has been fully consistent with that, as credits relative to GDP always grew slowly, at least when based on domestic deposit bases, and recovered only gradually from periodic crises. The implication in the context of a world downturn is that, as demand fell in almost all parts of the world, recovery based on financial and credit systems would be very gradual. Indeed, the complexity of the effects of the initial financial difficulties points to a strengthening of forces leading towards deeper depression rather than to an awakening of forces for recovery.

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